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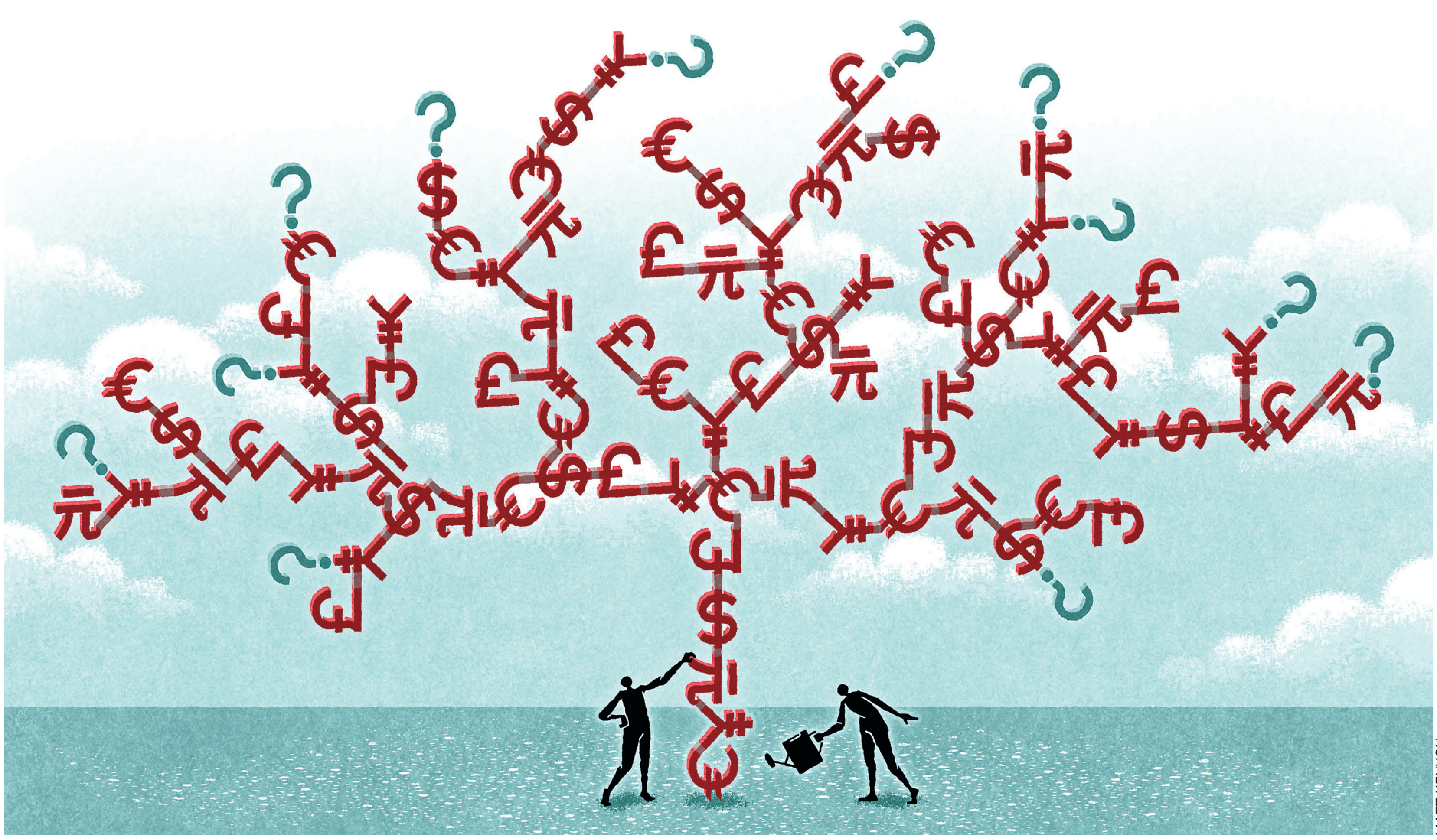

MATT KENYON

Success has its downside

Heady growth has stirred debate on issues ranging from intervention by central banks to trading speed and regulation, writes **Jennifer Hughes**

The dollar's plunge of more than Y3 against the Japanese currency in minutes this month, was a heart-in-the-mouth moment.

That almost unheard-of lurch is the drama any adrenalin junkie trader dreams of seeing. But equally, it produced the sort of frenzy that will rob them of sleep if they end up on the wrong side.

For 30 minutes, it was bedlam. Like the infamous "Flash Crash" that whomped US equity markets last May, this caught nearly everyone off-guard and its impact was magnified by its timing – at the thin end of the New York session but before Asian traders were up.

Although the market soon steadied, the drama was not over.

Less than 30 hours later, the Bank of Japan decided to act and convened the first Group of Seven co-ordinated intervention in 11 years. Yen bulls were forced to retreat sharply, as the central banks' many billions worth of yen selling kicked in.

Those two events, following the earthquake and tsunami, represented the excitement of FX, and also its importance, as the market is tied into the real economy more than any other.

It also breathed life into some of the market's perennial favourite debates. Does central bank intervention really work? What next for the carry traders borrowing cheaply in yen? What then for the high-yielding currencies such as the Australian dollar, that carry traders bought with their borrowed yen? Where is the renminbi in all of this?

The answers to all those are critical to market followers, and of interest to anyone with views on macroeconomic trends.

But they are only the trading-bet, surface-level questions that are being asked by the industry more broadly about the $4,000bn-a-day FX markets.

What will the FX market of the future look like? Will it still be dominated by the biggest banks? Is it really worth banks' time and money to be big in FX? How will regulation change the rules – and costs – of the game? How important, really, is trading speed?

The answers to all of the above are not clear – although everyone with a stake has a view.

Perhaps Sharon Bowles, the British MEP who chairs the influential economics and monetary affairs committee in the European Parliament, summed up the basics of the market most succinctly. "We're

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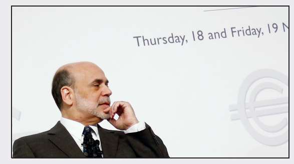

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FINANCIAL MARKETS SERIES

Action by G7 marks turning point for yen

Intervention

Peter Garnham on a see-saw ride for the Japanese currency

By any standards the movement in the yen after the devastating earthquake that hit Japan on March 11 was extreme. Within a week, it had surged to a record high against the dollar, hitting an all-time peak of Y76.25 on March 16.

The strength of the yen might appear counter-intuitive, given the damage to Japan's economy and the flood of liquidity pumped into the system by the Bank of Japan in the wake of the disaster to stabilise markets.

But the currency surged higher on speculation that Japanese institutions would repatriate funds to deal with the aftermath of the crisis.

Within hours, the yen reversed course, however, as central banks from the group of seven nations joined forces to weaken the Japanese currency in the first co-ordinated intervention campaign in 10 years.

Led by the Bank of Japan and followed by central banks in Europe and North America, the intervention took the yen quickly back above the Y80 level against the dollar.

Analysts say the G7 acted not just because the strength of the yen threatened the financial and economic stability of Japan, but because the trading pattern in the yen against the dollar had become disorderly and threatened global economic and financial stability.

"This type of volatility in currencies threatens much more than the economic recovery of the world's third-largest economy," says Camilla Sutton, chief currency strategist at Scotia Capital. "Above all, the G7's role was to stabilise global markets."

Analysts say history suggests that co-ordinated intervention is more effective than unilateral efforts to change the direction of a currency. Indeed, the Bank of Japan's unilateral effort to weaken the yen in September and the Swiss National Bank's campaign to weaken the Swiss franc met with only limited success.

By contrast, the campaign to support the euro in September 2000, the last co-ordinated action by leading central banks to intervene in the currency markets, and the joint US and Japanese efforts to weaken the yen in 1995 were successful in changing the fortunes of both currencies.

Derek Halpenny, European head of global currency research at Bank of Tokyo-Mitsubishi UFJ, says the current bout of co-ordinated intervention should be a game changer for the yen.

"The difference between occasions when there as been intervention by Japan has on a unilateral basis and when intervention has been multilateral is evident," he says. "This co-ordinated action is likely to follow the familiar historic pattern of marking a key turning point in the trend of the yen."

Some analysts predict that the action to stabilise the yen, and the resulting boost that it gave to asset markets, could see its use as a funding currency in carry trades rise.

The re-emergence of this activity, in which the low-yielding yen is sold to finance the purchase of riskier, higher-yielding assets elsewhere, could compound the effect of intervention and take the yen lower still.

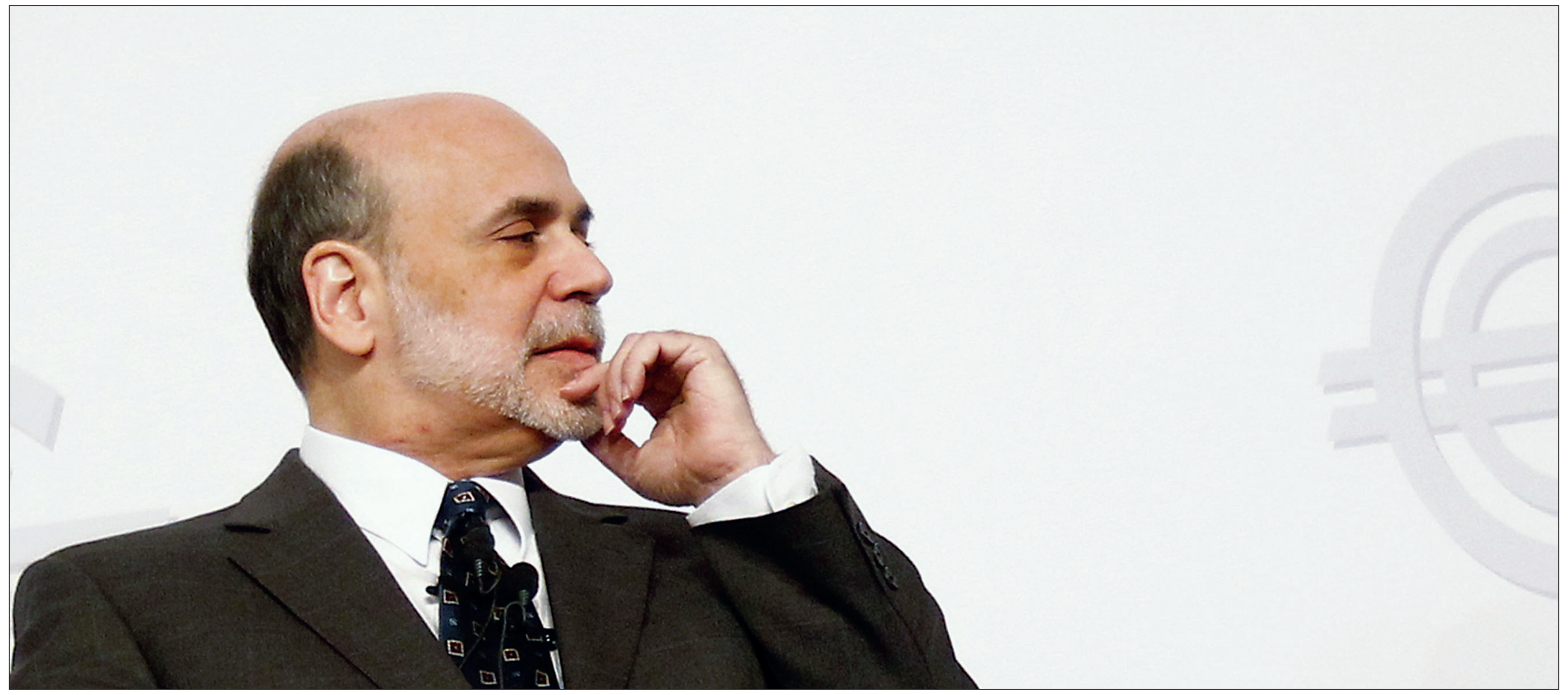
Michael Taylor, strategist at Lombard Street Research, believes the yen will be weak, with or without G7 intervention. He says its appreciation since the earthquake is not just counter-intuitive, but irrational.

There is no evidence, Mr Taylor says, that repatriation of funds by Japanese institutions is taking, or is about to take, place. "Economic fundamentals run clearly in the direction of a weaker yen," he says. "A shock from a natural disaster reduces the supply potential of an economy, so the real exchange rate should fall."

Mr Taylor adds that a longer-term effect could be the return of inflationary pressures in Japan as reconstruction takes place, which could push Japanese government bond yields higher. This, in turn, could focus investor attention on the country's public finances, which, he says, are about to become even more unsustainable.

In the short term, there remains the risk that investors test the resolve of the world's central banks and push the yen back towards its highest levels.

But the measures introduced in response to the earthquake, and the likelihood that Japanese monetary policy remains loose to deal with the crisis, as other leading central banks begin to raise interest rates, is likely to put the yen on the back foot.



Ben Bernanke making his speech in Frankfurt in November: US policymakers have not wavered Reuters

Growing sense of appreciation for new approach

Emerging markets

The global currency 'war' is turning into a battle against rising prices, says **Peter Garnham**

A ceasefire may be called in the global currency "war", as emerging market policymakers recognise the advantages of a strong exchange rate in fighting inflationary pressures.

This means that investors betting on further appreciation of emerging market currencies may be well rewarded.

In September, Guido Mantega, Brazil's finance minister provoked a strong reaction after declaring that the world was in an "international currency war", as policymakers across the globe struggled to weaken their currencies in an effort to maintain the competitiveness of their economies.

In the following months, a host of emerging market countries, including Brazil, Thailand and South Korea, introduced capital controls to fight speculative inflows that were threatening to push their currencies higher. Meanwhile, other countries stepped up intervention efforts to rein in their currencies.

The moves were a broadside at the Federal Reserve's implementation of a second round of quantitative easing, which many saw as a deliberate attempt to guide the dollar lower.

> 'Conditions for currency wars are now less compelling'
>
> **Benoit Anne, Société Générale,**

But US policymakers never wavered, with Ben Bernanke, Fed chairman, making it clear that emerging market authorities were responsible for goods and asset price inflation in their economies.

In a speech in Frankfurt in November, Mr Bernanke said: "An important driver of the rapid capital inflows to some emerging markets is incomplete adjustment of exchange rates in those economies, which leads investors to anticipate additional returns arising from expected exchange rate appreciation."

As the Fed continued with its second round of quantitative easing, the dynamics for emerging market policymakers changed, with commodity prices, including food prices, boosted by the flood of liquidity and the resultant growth. Meanwhile, growth in developed markets rebounded, prompting an outflow of funds from emerging markets.

"This has forced many emerging market policymakers to move away from posturing on currency to the more immediate business of quelling domestic inflation," says Bhanu Baweja, strategist at UBS.

"This is especially true for large, closed economies such as Brazil, where export strength was never that material to overall growth."

He says a 3 to 5 per cent appreciation in their currencies, which is what most emerging market countries have experienced since Mr Mantegna mentioned currency wars, is not nearly enough to compensate for the 20 to 25 per cent rise in energy and soft commodity prices since then, but is better than a 10 per cent depreciation.

Mr Baweja says the crucial point for investors now is to identify which countries are most likely to accommodate currency appreciation to neutralise rising price pressures.

Based on economic momentum, valuations and policy rhetoric, he says the most likely candidates are Singapore, Indonesia, the Philippines, Israel, Poland, the Czech Republic, Russia, Brazil and Chile.

"Many of these countries have already made the switch in favour of currency appreciation, but there is more to go on this trade," says Mr Baweja.

Benoit Anne at Société Générale says currency wars were a hot topic a few months ago, but outflows from emerging markets have seen the issue recede.

"Conditions for currency wars are now less compelling," he says.

Mr Anne says the rouble offers a buying opportunity for investors, as the Russian central bank has shifted away from a policy of exchange rate targeting towards an inflation target.

This implies that Russia will increasingly use higher interest rates to conduct monetary policy, rather than tightly managing the value of the rouble as it has done in the past.

Koon Chow, strategist at Barclays Capital, says that as commodity prices rise, emerging market policymakers' tolerance of currency appreciation, especially in Asia, will also increase.

He says that previously, when Asian central banks were more confident over growth, they took the view that rising inflationary pressures could be dealt with by raising interest rates.

But the prospect that higher energy costs could weigh on growth makes the danger of raising interest rates higher for Asian central banks than previously.

Mr Chow says that, while Asian central banks will probably tighten borrowing costs, they are more likely to let their currencies rise, although he expects them to continue to "lean against the wind" and damp any sudden surge in exchange rates.

Indeed, he says he is more bullish for the prospects of Asian currencies than for those in Latin America, where policymakers are still focused on stopping short-term financial inflows driving up their exchange rates.

Nevertheless, emerging market policymakers are likely to be less concerned over excessive exchange rate appreciation in the coming months, it appears.

As Mr Baweja says, the currencies battle was just a skirmish. The real war for emerging market policymakers is against inflation.

Success has its downside for $4,000bn-a-day market

Continued from Page 1

human and so we hedge," she told an industry gathering arranged by the ACI, a wholesale markets group, last month in London.

For participants, the line was both a reiteration of one of the pillars of the FX market – the need to cover the currency risks of cross-border deals – and a welcome reassurance that at least some policymakers understand their market's special nature.

Since the depths of the financial crisis, FX insiders have become adept at explaining those characteristics – namely the market's primary function as part of the global payments system and its role in helping companies and investors hedge risk.

But this can seem to sit a little uneasily – in politicians' eyes, at least – next to the fastest-growing part of the market – namely those who view FX simply as an investable asset class where speculators may play.

All this makes for a challenging environment for the biggest. Should they follow the volumes, and spend a fortune on technology to attract the high-frequency customers that offer trading fees but have flighty loyalty, or cater for the base – slower-moving corporate clients and institutional investors, who nonetheless have extensive needs of their own?

The answer for the biggest banks, it seems, is all of it.

"To truly be a top player, you have to serve every investor segment in every geography," says Anil Prasad, global head of FX at Citigroup, one of the three biggest banks in the market.

This comes at a cost, of course, but Mr Prasad is clear on the benefits. "By serving everyone, you accumulate the maximum amount of information, which helps you improve your business, and can create a virtuous circle.

"You gather information on every price you make and take, and from talking to all types of clients all around the world. The key is to have the technology to integrate this information, analyse it well, and disseminate it efficiently. If you can do those things, you can create a highly valuable proposition," he says.

The biggest banks take pride in the risk they manage. Although FX makes low demands on a bank's balance sheet, it still involves the need to take significant positions.

"Being an FX bank isn't about making prices for £1m at busy times, it's about making prices for £30m at the wrong – illiquid – time of day," says Ian Green, head of fixed income e-commerce at Credit Suisse. "We provide prices in large size to clients at our own risk constantly. A lot of science is applied to finding the optimal level of price consistency in turbulent or sketchy markets."

Meanwhile, many of the non-bank platforms are also thriving, streaming prices from banks and elsewhere to a growing, and increasingly savvy customer base. This too throws up challenges.

"Different client segments within the FX market have varying needs," says Mark Warms, general manager for Europe at FXAll, one of the oldest and most established platforms.

"While speed and price are paramount for high-frequency traders, others are looking for best execution, control and compliance."

Whatever their backgrounds, most industry participants are agreed on one thing: they are working in a growth industry with real potential.

"The mega-trends in FX are globalisation and, to some extent, technology," says Kevin Rodgers, global head of FX spot, e-trading and derivatives at Deutsche Bank. "Are these changing? We don't really see it. There isn't a big move to deglobalise the world's economy.

"Put that with people becoming more educated about currency risk and trading becoming easier, and there's a clear basis for further growth."

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Can star performers avoid fall to earth?

Commodity link

Rate differentials may chip away at the resource-rich nations, says **Peter Garnham**

Commodity-linked currencies have been star performers on the foreign exchange market since the middle of last year, boosted as raw material prices have surged higher.

The Australian dollar has risen more than 18 per cent against the US dollar since last June, breaking through parity and standing close to its highest level in 26 years.

The currencies of other resource-rich nations have also benefited, with the Canadian dollar climbing more than 6 per cent against its US equivalent since the start of the second half of last year, the Norwegian krone rising nearly 14 per cent and the New Zealand dollar rising more than 7 per cent.

But after such a strong run, investors are now more wary of betting on further blanket gains for the currencies of resource-rich countries.

"Commodity-linked currencies have tended to trade as a bloc, but the market may well become more discriminating," says Adam Cole, head of FX strategy at RBC Capital Markets.

The dominant driver of moves on markets over the past year has been risk appetite, which has resulted in high correlations developing between asset classes.

This so-called "risk-on/risk-off" dynamic has meant that as equities and risk appetite rose, so perceived risky assets such as commodity-linked currencies also climbed in lock-step and vice versa.

Mr Cole argues, however, that as the global economy recovers, so interest rate differentials between countries are increasing. This means that interest rates are set to become an increasingly important driver of currency movements, gradually taking over from risk appetite.

"While commodity-linked currencies share some characteristics, they all have features that go beyond their commodity status," he says.

"Those with central banks that have the buffer of being able to raise interest rates above current levels are likely to find support."

Mr Cole says this means that the Australian dollar, which has been the best performing commodity-linked currency in recent months, might struggle to build on those gains, given that the Reserve Bank of Australia is already close to normalising monetary policy.

The RBA has raised interest rates seven times since October 2009, taking its main lending rate to 4.75 per cent.

In contrast, he says, the Canadian dollar appears to have room to appreciate, given that the Bank of Canada is at the early stages of normalising monetary policy, having so far just raised rates by 75 basis points to 1 per cent.

Tim Carrington, head of foreign exchange at RBS, agrees that the breakdown of the "risk-on/risk-off" dynamic means performances will diverge from commodity prices. This is likely to eliminate the dynamic that has seen rising optimism push raw material prices higher across the board.

This means that while rising oil prices, for example, are likely to support the Norwegian krone and the Canadian dollar, they are unlikely to underpin, say, the New Zealand dollar.

"You have to take a view on commodity prices," says Mr Carrington. "Commodity markets are now set to differentiate, so FX markets will differentiate between commodity-linked currencies."

Many put the performance of commodity-linked currencies down to the Federal Reserve's decision to introduce a second round of quantitative easing in the second half of 2010. This drove a wall of money into financial markets, driving up asset prices across the board.

Much of this money was diverted into emerging economies, particularly in Asia, which have continued to outperform big developed nations.

In turn, rampant commodity demand from emerging market countries has boosted the economies of resource-rich nations, pushing their currencies higher.

Rio Tinto copper processing plant in Australia. The country's dollar has recently been the best performing commodity-linked currency Bloomberg

The resulting effect on monetary policy has also boosted commodity-linked currencies, with central banks in resource-rich nations seen as more likely to raise interest rates than those in the US, Japan, the eurozone and the UK.

Analysts say that the Australian and Canadian dollars have also benefited from demand from global reserve managers, however.

Reserve managers hold some $9,000bn, according to the latest figures from the International Monetary Fund. These funds have traditionally been held predominantly in dollars, euros, sterling, yen and to a lesser extent Swiss francs.

However, over the past two years there has been a marked shift in the make-up of these reserves, with managers diversifying away from those traditional currencies.

The proportion of reserves held by managers in what the IMF defines as "other currencies", which analysts believe to be mostly Australian and Canadian dollars, has risen from 2 per cent to 4 per cent.

Mansoor Mohi-uddin, head of foreign exchange strategy at UBS, says the reason for the shift by reserve managers is not just favourable interest rate differentials and the fact that Australia and Canada came through the financial crisis relatively unscathed.

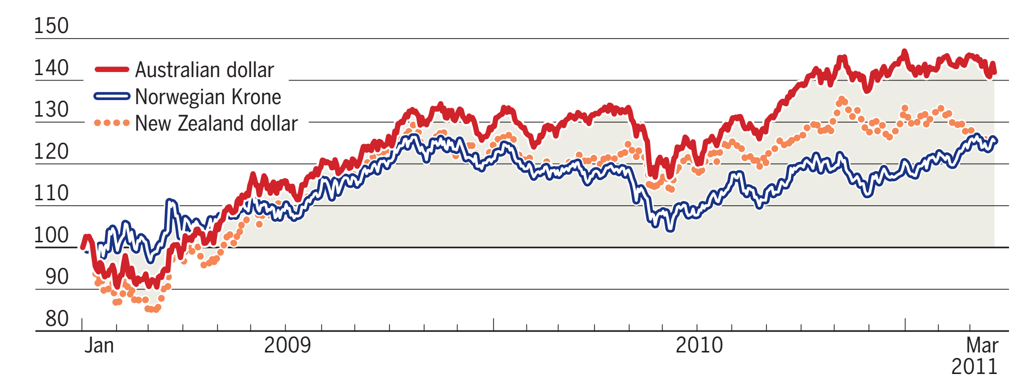
He says that the shift also reflects the fact that Asian central banks, the world's largest reserve-holders, are bullish on their own growth prospects.

"It is a strategic move into the currencies of nations that produce commodities and which Asian central banks believe will be in demand," says Mr Mohi-uddin. "The Australian and Canadian dollar are underpinned by this bullish view on commodities."

He says that, while a lot of the good news from the bullish commodity story is probably already priced into the value of the Australian and Canadian dollars, any pullback, such as that provoked by the recent earthquake and subsequent nuclear crisis in Japan, is likely to be met by demand from reserve managers.

"The Australian and Canadian dollars probably will not make much progress from here, but are likely to remain in historically high ranges," says Mr Mohi-uddin.

Commodities currencies
US dollar per currency (rebased)



Source: Thomson Reuters Datastream

Industry pleads its case against rules forged in heat of crisis

Regulation

Senior FX figures say the sector needs to be treated separately, writes **Jeremy Grant**

"If it ain't broke don't fix it".

That is essentially the argument being used by the foreign exchange markets against what many in the industry fear may be new regulations that would impose fresh obligations on them, thanks to G20 reforms being pushed in the wake of the financial crisis.

Under these reforms – enshrined in the Dodd-Frank act passed by the US administration last July – "standardised" over-the-counter (OTC) derivatives are to be traded on exchanges or another new type of electronic platform known as a "swap execution facility" (SEF).

In Europe, similar proposals, enshrined in a review of the Mifid directive, would involve a version of the SEF, provisionally called an "organised trading facility" (OTF).

At the same time OTC derivatives that are eligible for trading in this way are to be processed through clearing houses, to help safeguard the financial system against the fallout from another big default akin to that of Lehman Brothers, which triggered the crisis in 2008.

Taken together, these measures mean that swathes of OTC derivatives, including interest rate swaps and credit default swaps will have to be – and in some cases already are being – handled very differently from the way they were handled before 2008.

Dealers will relinquish control of markets they have long dominated through bilateral arrangements among themselves, while market participants and users of OTC derivatives – which include industrial companies and pension funds using such contracts for hedging – will have to pay costs associated with the margin payments that clearing needs.

If FX swaps and forwards have to be traded on SEFs that would spell the end of bank single-dealer platforms, in which they have invested a lot.

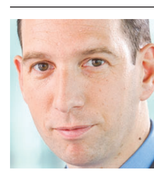
Yet the FX industry is nervous. To its members, FX played no part in the crisis of 2008. The FX markets were one of the few that functioned almost flawlessly through the crisis and in its aftermath. So, why sweep up FX in these reforms, imposing additional costs on end users?

Hubert de Lambilly, global deputy head of FX trading at BNP Paribas, warns that the effect on clients would be higher transaction costs because of clearing and reporting requirements.

"Clients will also face much higher funding costs, as they will not only have to provide collateral against the potential negative mark-to-market, but also initial margins," he says.

Officials formulating regulations in the US and Europe have listened to the FX industry's entreaties.

But there are no clear signs that its views may yet prevail, because – as one European banker puts it – policymakers are still being driven by the strong political impetus to re-regulate the financial system, as seen in the G20 initiative.



Clients could face higher transaction costs, warns Hubert de Lambilly

The FX industry's arguments are still seen as special pleading in this context. Regulators seem leery of setting precedents with exemptions that may end up being demanded by other parts of the markets.

Yet Joe Norena, chief operating officer for FX and commodities at HSBC, says: "We all need to understand where the real risks are in the global payment systems and work on real solutions to mitigate them as opposed to a one-size-fits-all approach to regulation."

The FX industry is concerned that regulators are using the term "swap" to apply to what are not swaps, or derivatives, in any case.

The Association for Financial Markets in Europe (AFME), which represents banks and brokers in OTC derivatives, fixed income and FX, says FX forwards and swaps differ from other financial derivatives in three ways.

First, there are no "contingent outcomes" involved in these transactions. This means they do not rely on the characteristic of an underlying asset on which they are based changing over the life of the contract – as in interest rate derivatives. The cash flows are known at the outset of the trade.

Second, they are short-term, with only 16 per cent of outstanding contracts exceeding two years' duration, compared with 55 per cent for interest rate swaps and 40 per cent for equity derivatives.

James Kemp, managing director of the global FX division at AFME, says: "That's one of the arguments that we have to make. They are called derivatives but it's a convenient naming for what are actually cash products. It's a crucial point."

Third, the main risk involved in FX deals is not the credit risk associated with having to mark to market regularly, but settlement risk.

AFME and others argue that settlement risk is already dealt with in FX through the use of CLS Bank.

Eric Litvack, head of public affairs at Société Générale corporate and investment banking, says: "The interests of systemic risk reduction would be better served by extending the coverage of CLS than by imposing central clearing."

In the US, there were signs this month of some hope for the FX camp, with reports that the US Treasury is close to exempting FX from the Dodd-Frank requirements.

European regulators are still debating whether FX derivatives should be cleared.

Mark Warms, general manager, Europe, at FXall, an electronic FX trading platform, says: "We know that policymakers in the US and Europe have been closely co-ordinating their efforts on regulatory initiatives. Therefore, whichever way the US moves on FX regulation, will be a good indication of the route that Europe will probably take".

Focus on speed blurs big picture

Trading trends

'Fastest' has been equated with 'best' but the obsession with velocity does not apply to the whole market, writes Jennifer Hughes

There is an old story about two men in the Serengeti who spot a lion heading towards them. One starts putting on his running shoes. The other asks why, since the lion can outrun either of them. The first man replies "I don't need to outrun the lion, I just need to outrun you."

With trading speeds already in the milliseconds and the bold prepared to declare only the speed of light as a final barrier, the FX market can look like the second man, thinking only about the absolute picture, rather than his relative role in it, and rushing, helter skelter, to boost trading speed.

The importance of technology and speed is certainly clear; not for nothing did Deutsche Bank call its cross-asset platform "Autobahn", after Germany's speed limit-free motorways, while Citigroup played on its name with its "Velocity" offering.

But drill down, and the picture is more complex, reflecting the different users of the FX market.

"With some parts of the market, we are getting to a point where the speed of light is a constraint," admits Kevin Rodgers, global head of FX spot, e-trading and derivatives at Deutsche Bank, but he is quick to add that this is by no means the whole picture.

"Even in the speed-oriented bits, it's not purely about that, but also about deal acceptance and processing, and risk management," he adds.

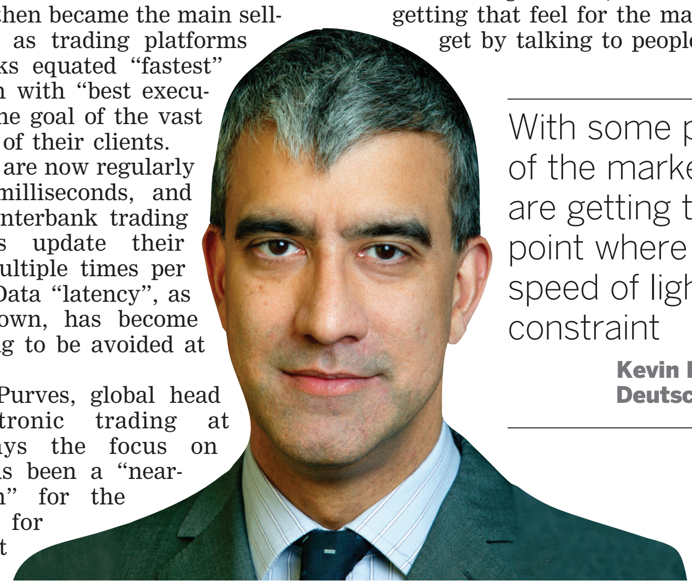
Trading speed used to be about not being the second man and being picked off by nimbler players, such as the high-frequency traders who use algorithms to make, and take, prices many times each second. They moved over from equity markets in the early to middle part of the last decade and forced banks to speed up or lose money by arbitraging their offered prices.

Banks were unhappy, but responded, and many executives now privately admit the "algos" made them much better.

Speed then became the main selling tool, as trading platforms and banks equated "fastest" execution with "best execution" – the goal of the vast majority of their clients.

Trades are now regularly in the milliseconds, and the big interbank trading platforms update their prices multiple times per second. Data "latency", as it is known, has become something to be avoided at all costs.

Chris Purves, global head of electronic trading at UBS, says the focus on speed has been a "near-obsession" for the market for about four years, but he believes that is changing.



"We've got to the point where you need to be fast, but faster from where we are doesn't make that much sense and there are diminishing returns to gain from going there," he says.

"There's a small number of players operating on exchanges and running price arbitrage programs for whom it is important that they're the fastest. But they're limited to a very specific purpose and that doesn't apply in the same way to the rest of the market."

Algo trading has, however, become the biggest single driver of the growth in FX. Data from the Bank for International Settlements shows overall FX volumes jumped 20 per cent in the three years to April 2010. The report noted that this was led not by banks, but by an increase in activity from "other financial institutions", a group that includes hedge funds, pension funds, smaller banks, other investors, insurance companies and central banks – and algos.

Most tellingly, the leap in overall volumes was driven by a 50 per cent surge in spot trading, particularly in the leading currencies, where algo traders tend to play because they are the most liquid.

For those serving that market, the issue is not now so much speed as co-location. Started by high-frequency traders in equities, the trick is to move servers next to a trading platform's matching engine to shave milliseconds off the time it takes to trade.

"We're at a tipping point," says Harpal Sandhu, founder and chief executive of Integral Development, which operates electronic trading networks. "Trading isn't going to get much faster than a few dozen microseconds – physical machines don't run faster than that. But in future, its not going to be feasible for a lot of market participants to operate without being co-located."

While the speediest corner of the market is focused on such arcane issues, others say phone trading is making a comeback, pulling the market potentially full-circle to its beginnings in the 1970s.

"Phone trading isn't dead, even if technology is involved," maintains Steven Braithwaite, director of FX trading at RBC Dexia.

"We're seeing more clients who want to trade over the phone and confirm electronically. They're looking at 10 banks' trading screens, but they're not getting that feel for the market you get by talking to people.'"

> With some parts of the market, we are getting to a point where the speed of light is a constraint
>
> **Kevin Rodgers, Deutsche Bank**

So where do they make their money?

Trading places: when it is politically attractive to be able to show banking as a utility, FX looks good Reuters

Profitability

The utility side of the business may not be so lucrative but big banks say they need to cover everything, writes Jennifer Hughes

As markets reopened on the Monday following the Japanese earthquake, one bank's client wanted to move out of yen, dumping billions on that bank.

As it happened, the yen rallied on expectations of repatriated funds after the disaster, but without knowing that, the bank had still taken on a multibillion risk in rollercoaster markets and its dealers took hours to offload the currency carefully without revealing its position or moving markets.

In a climate where it is politically attractive to be able to show banking as a utility, FX looks good. Facilitating the exchange of one currency for another, as in the above story, is primarily a payments service and, like others, one to which banks are well suited.

But the utility side of banking is not usually where the money is to be made. FX requires a vast and sustained technology spend and offers wafer-thin price margins. Yet since the crisis, more banks have announced their intention to develop their FX platforms. Put bluntly, what's in it for them?

To some extent, any bank dealing with cross-border investors and companies must offer FX services. But there are today many ways of "white-labelling" a service from another bank without having to make the full investment the business requires. This reduced option has been taken by many of the smaller banks.

"It's the old business maxim: either you get big, you get out or you find your niche," says Alan Bozian, chief executive of CLS bank, the market settlement system, and a veteran of the industry.

Outside the niche group, where they exist, the bank FX market has been consolidating among a handful of the biggest.

According to recent Bank of England data for the UK, the heart of the FX market, the 10 banks with the biggest FX turnover accounted for 77 per cent of the market in 2010, up from 70 per cent three years previously. The top 20 have more than 90 per cent of the market.

"There are economies of scale for us," says Kevin Rodgers, global head of FX spot, e-trading and derivatives at Deutsche Bank, the biggest FX bank globally. "In terms of our tech spend, for example, we can leverage off the money we spend in fixed income and equities on this to make our FX offering better."

Mr Bozian likens the biggest banks' offering to the economics of an assembly line. "They've all built the FX equivalent of the Ford Motor plant in Dearborn, Michigan. It's bought and paid for and now they need to run as much product through it as they can."

> '[The banks] have all built the FX equivalent of the Ford Motor plant in Dearborn, Michigan'

Not all clients, or market segments, are equally profitable. Top of the profitability tree are the emerging markets, where spreads between bids and offers are wider and trading volumes in the biggest currencies are growing rapidly.

Exotic options also offer wider margins because of their bespoke nature. Spot trading in the biggest currencies – the so-called G10 – is the bread-and-butter of any FX operation. Retail trading, a fast-growing part of the business, is probably the least profitable.

But the biggest banks are adamant they need to cover everything.

"Every segment of the market carries its own value, so you have to be pragmatic and approach as many segments of the market as you can," says Nick Howard, global head of FX and emerging markets distribution at Barclays Capital.

"You want a diverse set of clients because no one segment is always going to provide robust liquidity and the depth of market you need."

The segment everyone has been chasing is hedge funds. Mostly these are the high-frequency algorithmic outfits that trade multiple times a second. Many of the top industry surveys are heavily based on volumes, making these customers particularly attractive.

However, in terms of value, not everyone agrees.

"They're the umbrella in the sunshine that isn't there when it starts to rain because just when the market gets bumpy, they pull out and take their liquidity away," says Morgan McDonnell, head of FX markets and products at RBC Dexia.

"A lot of institutions are going back to their underlying clients – the corporates and the investors who want emerging markets and hedging advice to go with that. That's the long-lasting business."

One bank executive broadly agrees: "They're a spectrum. Some have value and can smooth price action, but many do have low social utility. You get volume from them, but it's low margin."

Trading volumes are only one part of the business and many executives are focusing on developing other services – and also connecting their operations more closely to the rest of the bank, for example embedding FX in other business lines to generate new demand.

"You need to do big volumes, but that's not enough to be successful today. Its about seeing how FX can fit in with other asset classes and talking to different groups of clients," says Frederic Boillereau, global head of FX and Commodities at HSBC.

"Its about offering other businesses – prime brokerage, custody services and payment and cash management, not just trading."

Talk to senior FX executives today, and they can sound like any web service provider with discussions on the importance of content, user-friendly interfaces and the need for technological strength.

Yet underneath, they are still the traders they generally began as, with a deep love of the market. Many even still trade.

"We've got it all," says Mr Boillereau. "Corporate deals, the retail flows, pension funds, the insurers and Juan Bloggs looking for Bric investment products. But the primary goal of FX is to transact business across borders and it always will be. That's a good place to be."

'Redback' puts the brakes on

Renminbi

Speculators betting on even modest gains for the Chinese currency may lose out, writes **Josh Noble**

The rise of the renminbi appears inexorable. The Chinese currency hits fresh record highs on a regular basis, making the appeal of the "redback" as an investment clear.

China's economy is in the ascendancy, and its currency will go with it.

Hong Kong is where China's currency meets international investors – permanent residents in the city can open renminbi bank accounts, and buy up to HK$20,000 ($2,565) worth every day. Appetite looks robust – renminbi as a share of Hong Kong's retail deposit base grew from 0.1 to about 5 per cent during 2010, according to the Monetary Authority, the city's de facto central bank.

Because of the Chinese currency's lack of convertibility, the main reason to hold it remains for speculation. HSBC offered a payroll facility for clients wanting to pay staff in renminbi, but so far there have been no takers.

"The average Hong Kong resident views the renminbi itself as a half-decent investment opportunity," says Mark McCombe, chief executive of HSBC's Hong Kong operations. "It may not be long before taxi drivers and restaurants start accepting it. But for most people – they are paid in Hong Kong dollars, they buy things with Hong Kong dollars, their lives are in Hong Kong dollars."

For all the hype about the rise of the redback, those banking on even modest gains may be disappointed.

At the start of March, Yi Gang, deputy governor at the Chinese central bank, said the renminbi exchange rate was at its closest yet to "equilibrium". The powerful manufacturing lobby is also worried about further appreciation, putting pressure on the government to keep the redback's rise in first gear.

Since the People's Bank of China announced it was moving to a slightly more flexible exchange-rate regime last June, the renminbi has returned to its path of gradual appreciation. But in that time it has risen just 4.3 per cent, outperforming only a handful of currencies in the region, including the Pakistani rupee and the Vietnamese dong.

Only four currencies in Asia have moved less in any direction. Meanwhile, the Japanese yen has leapt 13 per cent, the Singapore dollar 10 per cent and the Korean Won 9.5 per cent.

The action in the forward market suggests continued plodding gains. Non-deliverable forwards – or NDFs – are essentially a derivatives contract pricing future values. Over the next 12 months, the market points to less than 2 per cent of further appreciation.

While the more bullish forecasts point to a rise of anything up to 6 per cent, consensus is for 4.1 per cent by year end, according to a recent poll of economists by Bloomberg. Many analysts remain doubtful.

"Over the next year or so, investors may be disappointed. It's not undervalued by as much as some would hope," says Ashley Davies, senior FX strategist at Commerzbank in Singapore.

Inflation is also a factor. China's prices surged at the end of 2010, prompting a round of monetary tightening from the central bank.

China has used a stronger currency to help damp the effects of imported inflation – principally caused by rising commodity prices. So long as China is battling inflation, there is potential for faster appreciation. But that may be a temporary phenomenon.

"Once China gets a grip on inflation, there could be a reduced need for appreciation," says Albert Leung, FX strategist at Citi. "The [renminbi] is no longer as undervalued as a few years ago. It will still appreciate, but it's not going to be exciting. Over the longer term, we're likely to see more modest appreciation, and more two-way risk."

Some analysts go even further. TJ Bond, chief Asia economist at Bank of America Merrill Lynch – though bullish on the currency – says the renminbi "is not significantly undervalued", and will even become overvalued during the next few months.

"On a risk/reward basis, it has exceeded any other currency in the region," says Daniel Hui, senior FX strategist at HSBC.

One thing that might facilitate a more rapid rise of the redback is a faster opening up of the Chinese capital account. Beijing maintains strict controls on money flowing in or out of the mainland for investment. Pilot projects to allow residents in Wenzhou and Shanghai to invest overseas suggest that authorities are looking at new ways to liberalise some of those restrictions.

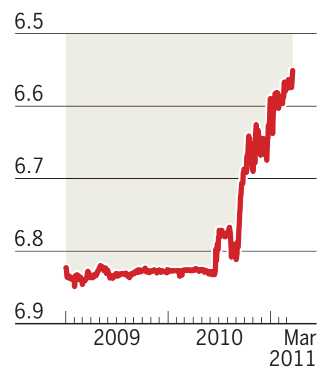
"Historically, economies have either had an open or a closed capital account. Once you choose to open it, it feeds itself, making it very difficult to open the capital account gradually in practice," says Mr Davies.

He believes a rapid opening of the capital account could push the renminbi to strengthen faster.

But the consensus view points to a slow pace of reform. "Gradualism has worked well for the Chinese. We've seen some important steps in the opening of the capital account, but it's a journey of a thousand miles", says Mr Bond.

Renminbi

Against the dollar (Rmb per $)



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